BLANK PAGE

FILE COPY

Library, Bureau of Mines, U. S.
FILED
OCT 18 1940
PULLMAN-STANDARD
CAR MFG. CO.

BLANK PAGE

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Specification of errors to be urged	4
Argument	5
Conclusion	16
Appendix	17

CITATIONS

Cases:

Almours Securities, Inc. v. *Commissioner*, 91 F. (2d) 427	12
Burnet v. *Sanford & Brooks*, 282 U. S. 359	9, 12
Carmichael v. *Southern Coal Co.*, 301 U. S. 495	9
Clark v. *Kansas City*, 176 U. S. 114	8
Crane-Johnson Co. v. *Helvering*, No. 8, present Term	2, 6, 7, 8, 9, 12
Helvering v. *Fitch*, 309 U. S. 149	15
Helvering v. *National Grocery Co.*, 304 U. S. 282	10–12
Long Beach Improvement Co. v. *Commissioner*, 5 B. T. A. 590	12
New Colonial Co. v. *Helvering*, 292 U. S. 435	15
Norfolk & W. Ry. Co. v. *McCoy*, 257 Ky. 32	15
Pruett v. *Midkiff*, 273 Ill. App. 142	15
Parker, John M., Co. v. *Commissioner*, 49 F. (2d) 254	15
Sanley v. *Wilkinson*, 107 Okla. 54, 229 Pac. 574	15
Schanbacher v. *Lucido Bros. Grocery Co.*, 93 S. W. (2d) 1076	15
Spicer v. *Henderson*, 43 S. W. 27	15
Steward Machine Co. v. *Davis*, 301 U. S. 548	9
Sugerman v. *Stelling*, 135 N. Y. Supp. 595	15
United Business Corporation v. *Commissioner*, 62 F. (2d) 754	12
Walker v. *McLoud*, 204 U. S. 302	14
Welch v. *Helvering*, 290 U. S. 111	15
Willcuts v. *Milton Dairy Co.*, 275 U. S. 215	12
Woolford Realty Co. v. *Rose*, 286 U. S. 319	9

258245—40——1

Statutes: Page

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1–A, Secs. 3803–24, 3803–25 17–20

Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 104 10

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14 2

Sec. 26 2

In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 121

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NORTHWEST STEEL ROLLING MILLS, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 14–18) is unreported. The opinions in the Circuit Court of Appeals (R. 77–85) are reported in 110 F. (2d) 286.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 1, 1940 (R. 85). The petition for a writ of certiorari was filed on June 1, 1940, and granted on October 14, 1940. The jurisdiction of this Court rests on Section 240 (a) of the Judi-

cial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in computing its "undistributed net income" for purposes of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, respondent, a Washington corporation, is entitled to credit under Section 26 (c) (1) of that Act on the ground that its charter and the state law constitute a written contract executed by the corporation, expressly dealing with and prohibiting the payment of dividends during the taxable year 1936.

2. Whether the undistributed profits tax, as applied to respondent, is unconstitutional.

3. Whether respondent has shown that it was prohibited by state law from paying out all or a part of its net income for 1936 as dividends.

STATUTES AND REGULATIONS INVOLVED

The federal statutes and Treasury regulations involved are set out in the appendix to the Government's brief in *Crane-Johnson Company* v. *Helvering,* No. 8, present Term, with which the present case is to be argued. The applicable Washington statutes are set out in the appendix to this brief, *infra,* pp. 17–20.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 14–15), may be summarized as follows:

Respondent is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington (R. 14).

Respondent's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71 (R. 14).

From 1926 to 1936 respondent was indebted in considerable sums to the Seattle First National Bank. This indebtedness was evidenced by ninety-day notes which were renewed from time to time. In January 1934, when respondent proposed again to renew the notes, then aggregating approximately $115,000, the officer of the bank who was handling the matter told respondent's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments of any available surplus remaining in respondent's treasury after satisfaction of its current operating expenses. Respondent was given to understand that in case of a breach of this condition the bank would apply for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by respondent which dealt with the payment of dividends. From January 1934 to July 1936, the amount of respondent's indebtedness to the bank

was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14–15.)

In computing its surtax on undistributed profits, the respondent claimed a credit of $75,085.26 as an amount which could not be distributed because of contracts restricting dividend payments. The Commissioner disallowed the credit and determined a deficiency of $13,628.22 (R. 6–12). The action of the Commissioner was sustained by the Board (R. 18–19), but the court below reversed, one judge dissenting (R. 82).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that in the computation of its "undistributed net income" for purposes of the surtax imposed by Section 14 of the Revenue Act of 1936, respondent is entitled to a credit under Section 26 (c) (1) of that Act.

(2) In failing to hold that respondent is not entitled to such a credit because its corporate charter and the laws of the state of incorporation do not constitute a written contract executed by the corporation expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1).

(3) In failing to hold that respondent did not prove that it was prohibited under local law from paying dividends during the taxable year 1936.

(4) In reversing the decision of the Board of Tax Appeals.

ARGUMENT

Under the laws of the State of Washington, a corporation is prohibited from paying dividends in cash or property except from surplus. Remington's Revised Statutes of Washington, Volume 5, Title 25, Section 3803–24, *infra*, pp. 17–19. In the court below respondent contended that during the tax year 1936 it had no surplus within the definition of the Washington law and consequently that it could not legally have paid dividends. It urged that its charter and the laws of Washington constituted a "written contract executed by the corporation prior to May 1, 1936" expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, and that consequently it was entitled to the credit claimed. It further contended that unless a credit were allowed by reason of the prohibition against the payment of dividends imposed by Washington law, the undistributed profits tax, as applied to it, would be unconstitutional. And finally it contended that the tax was invalid because it permitted a credit in the case of a *written* contract restricting the payment of dividends and denied a credit in the case of an *oral* understanding such as respondent's arrangement with the Seattle Bank. The Commissioner contended, on the other hand, that respondent's charter and the state law did not constitute a written contract executed by the corporation within the meaning of

Section 26 (c) (1), that the Act so construed was constitutional, and that in any event respondent had failed to prove that its financial situation was such that state law prohibited it from paying dividends.

The court below, after expressing the opinion that the Act was not subject to attack because of the different treatment accorded oral and written contracts restricting the payment of dividends, held, one judge dissenting, that respondent's charter and state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the taxpayer had proved that, under state law, it could not legally have paid dividends during the tax year, and that consequently it was entitled to the credit claimed.

I

The decision of the court below that respondent's charter and the state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1) is, we believe, clearly erroneous for the reasons set forth at length in Point I of the Government's brief in *Crane-Johnson Company* v. *Helvering,* No. 8, present Term, with which the present case is to be argued. Reference is made to the Government's brief in the *Crane-Johnson* case for the arguments in support of the Government's position here.

The only difference between the present case and the *Crane-Johnson* case on this issue is that

the Washington statute applicable here prohibits the corporation itself, as well as its directors, from distributing dividends except from surplus, whereas the prohibition of the North Dakota statute involved in the *Crane-Johnson* case is addressed only to the directors. Since, however, the principal contentions made by the Government in the *Crane-Johnson* case are not dependent upon the particular form of the North Dakota statute, this difference is without significance for present purposes.

II

In the court below, respondent advanced various arguments against the constitutionality of the undistributed profits tax, as applied to it, which are not available to petitioner in the *Crane-Johnson* case.

1. In the first place, it contended that the tax is invalid because it permits a credit in the case of a written contract restricting the payment of dividends and denies a credit in the case of an oral contract, such as respondent's arrangement with the Seattle Bank. In our view, this contention is not available to respondent. Respondent's indebtedness to the bank was fully discharged on July 6, 1936 (R. 15); the company could at any time thereafter have distributed its 1936 earnings by way of dividends without any possible violation of its understanding with the bank. It is plain, therefore, that even had Congress granted a credit to

corporations under oral contractual restraints against the payment of dividends, respondent would not have been entitled to the credit. In these circumstances, respondent cannot be heard to urge that the absence of such a credit renders the tax invalid. Cf. *Clark* v. *Kansas City*, 176 U. S. 114, 118.

But in any event, as the court below held,[1] Congress was amply justified in according different treatment to restraints against the payment of dividends imposed by written contracts and restraints imposed by oral contracts. Deductions or credits are a matter of legislative grace within the sound discretion of Congress and respondent is in no position to complain simply because the grace was extended to others and not to it. See Government's brief in the *Crane-Johnson* case, p. 44. Moreover, there was clearly a rational basis for the distinction drawn by Congress between oral and written contracts. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits the payment of dividends. But the existence and scope of oral contracts are not susceptible of ready proof, and it would impose a tremendous burden upon the Bureau if it were required to determine, every time a credit was claimed,

[1] The court below appears to have assumed *arguendo* (R. 79) the existence of an oral contract with the bank under which respondent was to apply its earnings to the payment of its indebtedness.

whether the alleged oral contract was really made, what its precise terms were, and whether it was valid under state law. Furthermore, the grant of a credit in the case of oral contracts would have presented an obvious method for tax evasion by unscrupulous taxpayers. These considerations plainly warrant the different treatment which Congress, in the exercise of its discretion, accorded to oral and written agreements. *Carmichael* v. *Southern Coal Co.*, 301 U. S. 495; *Steward Machine Co.* v. *Davis*, 301 U.S.548; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; see also the other authorities cited in the Government's brief in the *Crane-Johnson* case at pp. 46–47.

2. The other constitutional arguments advanced by respondent in the court below were that the undistributed profits tax constitutes an illegal federal interference with state power to control the distribution of corporate earnings in violation of the Tenth Amendment and that it is invalid because it is a "penalty tax."

It is apparent from the discussion in the Government's brief in the *Crane-Johnson* case (pp. 40–41) that the undistributed profits tax was enacted as a revenue measure. It was designed to prevent the avoidance of surtax by stockholders and to equalize the tax burden on all business profits, whether distributed or not, and whether realized by corporations or by unincorporated en-

terprises. The nature of the legislation as a revenue measure is not affected by the fact that the surtax was, in part, intended to induce corporations to distribute earnings which they might otherwise have accumulated, since the act so induced would result directly in increased taxes. Nor can the surtax be deemed to be a penalty rather than a revenue measure when imposed on corporations with undistributed earnings which, because of state law or otherwise, cannot be distributed. The imposition of the surtax on such corporations has as its direct result an increase in the amount of the tax payable; furthermore, it serves to equalize the tax burden imposed on the income of such corporations and on the income of corporations which distribute their profits. That these revenue purposes, rather than a purpose to penalize corporations which refuse to violate state law, motivated enactment of the statute scarcely needs argument.

Helvering v. *National Grocery Co.*, 304 U. S. 282, is persuasive authority against respondent's position. The Court there sustained, over precisely the same objections as are raised here, the constitutionality of Section 104 of the Revenue Act of 1928, which imposed a surtax on corporations formed or availed of to prevent the imposition of surtaxes upon their shareholders. The Court stated (pp. 286–289):

> 1. It is said that the statute violates the Tenth Amendment because it interferes with

the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754, 756.

* * * * *

2. It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon, ante,* p. 271. Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits. If it preferred, Congress could lay the tax upon the corporation, as was done by § 104. The penal nature of the imposition

> does not prevent its being valid, as the tax was otherwise permissible under the Constitution. Compare *Helvering* v. *Mitchell*, 303 U. S. 391.

See also *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754 (C. C. A. 2d); *Almours Securities, Inc.* v. *Commissioner*, 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666.

Respondent also suggested in the court below that "the tax is not on income at all, but is dependent upon what the taxpayer does with its income already taxed." (Reply Brief, p. 20.) To this contention, too, the *National Grocery* case is a complete answer. The tax is specifically imposed on income and it is not the less an income tax because a credit is given to the extent that the income, by being distributed, becomes taxable to the stockholders.[2] If the income is not distributed, the corporation pays the tax; if it is distributed, the stockholders pay the tax. In either event, the subject of the tax is the income itself.

III

There is also a serious question here, as in the *Crane-Johnson* case, whether respondent has

---

[2] It is clear that Congress can impose a tax on the net income of a corporation even though the corporation has a deficit. See *Long Beach Improvement Co.* v. *Commissioner*, 5 B. T. A. 590, cited with apparent approval by this Court in *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215, 220. See also *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

proved that it could not legally have paid dividends during the tax year 1936.

The applicable state statute (Remington's Revised Statutes of Washington, Vol. 5, Title 25, Section 3803–24, *infra,* pp. 17–19) prohibits a corporation from paying dividends "except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets". Section 3803–25 (*infra,* p. 19) imposes liabilities upon directors and stockholders declaring or receiving dividends paid in violation of law.

The record in this case shows, and the Board found, that respondent's surplus by appraisal at the beginning and end of 1936, the taxable year, was $134,173.90, that its operating deficit as of December 31, 1935, was $76,983.26, and that its net income for 1936 was $76,049.71 (R. 14). No certified financial statements of respondent are in evidence.

In our view, these findings do not justify the conclusion that respondent was prohibited by Washington law from paying out as dividends in 1936 its net profits of some $76,000. ' The mere fact that the taxpayer had an operating deficit at the close of 1935 would not have prevented it from declaring dividends out of its profits during the taxable year so long as it had sufficient surplus and

the record does not show that it did not have such a surplus. The record does show "surplus by appraisal" of some $134,000 and that would have been more than sufficient to cover dividends of $76,000 unless the surplus was created by "unrealized appreciation in value or revaluation of fixed assets" and the record does not show that it was.

The court below was of opinion that the requisite proof was supplied by the following testimony of respondent's vice president and general manager (R. 50):

> Q. Had the company ever been in a position to pay the bank in full prior to that time? [July 6, 1936.]
>
> A. No, sir.
>
> Q. Had it ever been in a position to pay dividends?
>
> A. Not that I know of.

In the first place, this testimony, whatever its probative value, appears to relate only to the period prior to July 6, 1936, when the indebtedness to the bank was discharged; under the oral agreement with the bank, no dividends could have been paid by the company prior to that time. There is no testimony at all that during the remaining six months of the tax year respondent could not have paid out all of its 1936 net earnings as dividends.

In the second place, this testimony, even though not objected to at the hearing, was a mere conclusion of law which does not constitute proof of the essential facts. See, e. g., *Walker* v. *McLoud*, 204

U. S. 302, 310; *Parker Co.* v. *Commissioner*, 49 F. (2d) 254, 256 (C. C. A. 5th); *Pruett* v. *Midkiff*, 273 Ill. App. 142, 145–146; *Norfolk & W. Ry. Co.* v. *McCoy*, 257 Ky. 32, 34. This is particularly true since the testimony involved the legal effect of the Washington statute, on which question the opinion of the witness was neither controlling nor material.

Respondent cites various state court decisions [3] to the effect that, in certain circumstances, improper evidence, if admitted without objection, must be treated as legal evidence. Assuming this to be the true rule, it does not avail respondent. We may concede that, in the absence of objection, the testimony here involved must be accepted as evidence of the witness' opinion concerning the capacity of the company to pay dividends, but it does not follow from this that the witness' opinion is of any probative force in establishing the facts concerning which the opinion was ventured.

It is plain that the burden of proof was upon respondent to show that it could not have paid dividends during the tax year without violating the state law. *New Colonial Co.* v. *Helvering*, 292 U. S. 435; *Welch* v. *Helvering*, 290 U. S. 111; *Helvering* v. *Fitch*, 309 U. S. 149. Petitioner having failed to furnish the requisite proof, neither the

[3] *Schanbacher* v. *Lucido Bros. Grocery Co.*, 93 S. W. (2d) 1076 (St. Louis Ct. of App.); *Sanley* v. *Wilkinson*, 107 Okla. 54, 229 Pac. 574; *Spicer* v. *Henderson*, 43 S. W. 27 (Tex. Civ. App.); *Sugerman* v. *Stelling*, 135 N. Y. Supp. 595.

Commissioner nor the courts are called upon to conjecture as to what the actual situation in 1936 may have been.

CONCLUSION

The decision of the court below should be reversed on the ground that the Washington statute prohibiting the payment of dividends except from surplus is not a provision of a written contract executed by the respondent within the meaning of Section 26 (c) (1) and that the undistributed profits tax, so construed, is constitutional. But if the Court should hold otherwise, the decision of the court below should be reversed on the ground that respondent has not sustained the burden of proving that the distribution of its net income for 1936 would have constituted a violation of state law.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
L. W. POST,
Special Assistants to the Attorney General.
RICHARD H. DEMUTH,
Special Attorney.

OCTOBER 1940.

APPENDIX

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1-A:

§ 3803-24. CAPITAL CARRIED AS LIABILITY—COMPUTATION—DIVIDENDS HOW PAID.

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities,

including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever, whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24.]

§ 3803–25. UNLAWFUL DIVIDENDS. If any dividend be paid in violation of section 3803–24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

U. S. GOVERNMENT PRINTING OFFICE: 1940

BLANK PAGE